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THE YEN SINCE THE PLAZA ACCORD

Summary

At times during 1988 the dollar has been worth only half as many yen as three years earlier. The two currencies have been roughly stable against each other during most of 1988, but the dramatic changes associated with the exchange rate realignment since 1985 are still being played out in Japan.

While it is customary to focus on the yen-dollar exchange rate and Japan's dollar-denominated current account balance, looking at other measures of both the value of the currency and the external balance reveals a picture sometimes at odds with those measures. And, while the realignment is usually dated as having begun with the Plaza Accord of September 1985, it may have started earlier in 1985, casting some doubt on the role of international economic policy coordination as exemplified in the accord.

Background

On September 22, 1985 the finance ministers and central bank governors of the world's five leading industrial countries held an extraordinary meeting at the Plaza Hotel in New York City. Their purpose, spelled out in one paragraph of a much longer document issued after the meeting, was clear:

> The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has

> been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective change in fundamentals, some further orderly appreciation of the non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.[1]

With this statement, the United States dropped the last vestiges of the so-called benign neglect of the dollar and agreed to work actively to reduce its value. The communique stood in marked contrast to a statement from the 1983 Economic Report of the President, released in February 1983:

> Since 1981 the United States has abstained as much as possible from direct intervention in the foreign exchange market. This unwillingness to intervene is based on doubts about whether exchange-market intervention is effective or desirable.[2]

September 22 was a Sunday in New York. Although it was Monday in Tokyo, the markets there were closed for a holiday. When the American and the European markets opened the next day, the reaction was swift. In London, for example, the dollar dropped in a single day by 3.5 percent against the yen and comparable amounts against the other currencies.

But many remained skeptical that a mere dictum from the economic officials of the Group of Five nations would be enough to drive the dollar down. While the communique recommended various measures for governments that would lead to a cheaper dollar, many experts felt the recommendations did not go far enough to spell out specific actions. Japan, for example, pledged "flexible management of monetary policy with due attention to the yen rate." In this case, Japan did respond, perceptibly, if temporarily, tightening monetary policy. The three-month gensaki interest rate jumped from 6.3 percent on average in July-September 1985 to 7 percent in the October-December period; long-term rates also climbed. The higher interest rates were designed to keep a portion of Japan's capital outflow at home and reduce the supply of yen on international money markets, driving the Japanese currency up. By the first quarter of 1986, however, both short- and long-term rates were below their July-September levels.

While the deliberations and the documents that led up to the Plaza Accord have not been made public, Yoichi Funabashi, a deputy editor of economic affairs at Asahi Shimbun has written about the process. He suggests that the

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[1]Announcement of the ministers of finance and the central bank governors of France, West Germany, Japan, the United Kingdom and the United States, September 22, 1985.

[2]Council of Economic Advisers, Economic Report of the President 1983 (Washington, D.C.: Government Printing Office, 1983), p. 68.

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officials had in mind a comparatively modest appreciation of the yen against the dollar over the short term. Mr. Funabashi describes discussions about whether the dollar should drop to the Y214-Y218 range, a 10 to 12 percent depreciation from its pre-Plaza level of Y242=$1.00, or sink further, perhaps to around 200 yen to the dollar.[3]

If the participants wanted a modest depreciation of the dollar, they got considerably more. The dollar fell rapidly, closing 1985 at Y200.5=$1.00 and plummeting to Y179.60=$1.00 by the end of the first quarter of 1986, a drop of 25.8 percent against the yen from the pre-accord level. One major factor was falling oil prices, which plunged more than 50 percent in dollar terms in the six months following the accord. The yen strengthened against the dollar as the Japanese demand for foreign currency to pay for imported oil declined.[4]

The individual Plaza Accord participants or their representatives met several times in late 1985 and in 1986 in an effort to keep the agreement on track. But by early 1987 the finance ministers and the governors appeared to have had enough. With the yen at Y154=$1.00, they met again, this time in Paris, on the weekend of February 21-22 to hammer out what has become known as the Louvre Accord. Japan was represented by its new finance minister, Kiichi Miyazawa, replacing Noboru Takeshita, who had participated at the meeting in New York. Canada and Italy were added to the five countries that had signed the Plaza Accord, although Italy stomped out of the meetings when it was not invited to a dinner of the original five. (Canada did not seem to mind the snub.) The result was a Group of Six communique, which said in part:

> The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.[5]

Having appeared to be successful at jump-starting the exchange rate adjustment mechanism a year and a half earlier, the ministers were now attempting to bring it to a screaming stop. Once again, skepticism abounded. The U.S. trade deficit had responded relatively little to the dollar depreciation to date, so it was hard to see why then-current rates were the appropriate ones if the object were to reduce external balances. Further, many doubted the efficacy of the Louvre commitments, which were supposed to improve the chances of obtaining exchange rate stability.

[3]Yoichi Funabashi, Managing the Dollar: From the Plaza to the Louvre (Washington, D.C.: Institute for International Economics, 1988), pp. 16-18.

[4]For a description of developments immediately following the Plaza Accord and how they affected the yen, see Takatoshi Ito, "The Intra-Daily Exchange Rate Dynamics and Monetary Policies After the G-5 Agreement," Journal of the Japanese and International Economies, I (1987), pp. 275-298.

[5]Group of Six Communique, February 22, 1987.

In the Louvre communique, Japan promised to:

> . . . follow monetary and fiscal policies which will help to expand domestic demand and therefore contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation [can] be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one-half percent on February 23.[6]

Japan has attempted every one of the initiatives laid out in the communique. So far only the effort at tax reform has fallen short, although Japan is now in the midst of a special Diet session called specifically to deal with this issue. The centerpiece of the Japanese effort to meet its promises outlined in the Louvre Accord was a Y6 trillion ($42.9 billion at a then-current Y140=$1.00) supplemental package of spending increases and tax cuts for FY 1987, which ran from April 1, 1987 to March 31, 1988 (see JEI Report No. 21B, June 5, 1987).

For a while the Louvre Accord seemed to be working. The yen-dollar exchange rate moved around a little but showed no clear direction during the spring and summer of 1987. For July 1987 it averaged Y150=$1.00, close to its February level of Y153. Furthermore, the policies that were supposed to be the glue that held the agreement together were jelling, at least in Japan. Japan's economy, which had been reeling under the impact of the high yen, was showing signs of coming to life, although the phenomenon is clearer in hindsight than it was at the time. Just as called for in the Louvre Accord, growth stemmed entirely from domestic demand, with external demand falling. In the July-September 1987 quarter real gross national product surged 8.4 percent on an annual basis.

Then the roof fell in, and policy disagreements between the United States and West Germany may have played a part. Interest rate changes here and abroad had the effect of making investment in the United States less attractive, altering the relative price of equities and bonds and, generally, undermining confidence. On October 19, 1987 (Black Monday) equity prices plummeted around the world, underscoring the interdependence of world financial markets that had been one of the reasons for policy coordination as exemplified in the Plaza and the Louvre Accords.

If Black Monday demonstrated the rationale for policy coordination, it failed to demonstrate its effectiveness. In fact, some argued, the exchange rate stability over the summer had created an illusion of equilibrium in the underlying economic relationships. Attempts to maintain that illusion, in this view, had led to the interest rate structure that had contributed to the crash. These analysts, in other words, blamed Black Monday in part on the Louvre Accord.

[6] Ibid.

The crash itself had ambiguous effects on the exchange rate. Americans pulling money out of the Tokyo stock market created a supply of yen as they moved to cash in their yen proceeds for dollars, pulling the yen down and pushing the dollar up slightly. From the Friday before Black Monday to the Friday after, the yen went from Y142=$1.00 to Y144. By early November, however, the effect appeared negative for the dollar, and the U.S. currency resumed its rapid descent. While averaging Y144 for October, the month of the crash, the dollar traded at only Y128.35 for December 1987. In late December the Group of Seven ministers reiterated their commitment to stable currencies. The yen closed 1987 at Y123.5=$1.00.

The first nine months of 1988 have largely been a replay of the same period of 1987, with the dollar stable or rising slightly against the yen. Should the stability last much past the first anniversary of Black Monday on October 19, the yen may end up higher at the end of 1988 than a year earlier (see JEI Report No. 40B, October 21, 1988). The recent stability makes it easy to forget that the yen has appreciated about 86 percent against the dollar (Y242 to Y130) since the Plaza Accord barely three years ago.

The Question of Coordination

The Plaza Accord was a turning point in the Reagan administration's policy toward currency markets. Rather than let the dollar find its own level, Washington agreed to intervene to help establish a value for the U.S. currency against other currencies. In so doing, Treasury Secretary James A. Baker III reversed the course set by the administration's first treasury secretary, Donald Regan. The new policy in some eyes amounted to a violation of the free-market principles that have driven so many Reagan White House positions. The Louvre Accord was an even greater departure: in essense, the agreement amounted to an effort to fix one of the economy's key prices, that of its currency.

The ministers and the governors who gathered in New York and later in Paris were smart enough to realize that their words alone could not command markets. Even if the central bankers threw billions into intervention, the currency markets would move only temporarily if the tens of billions that the private sector could command bet otherwise. In this sense, the officials bought the argument that price-fixing, whether of currencies, gasoline or other goods and services, is likely to be ultimately disappointing, regardless of its superficial appeal.

For this reason, the ministers went much further in the Plaza and the Louvre Accords: they agreed to take steps to change the fundamental supply and demand conditions for their currencies. With their sway over the money supply and influence on government tax and spending decisions, economic policymakers around the world come far closer to controlling the commanding heights than they do the everyday operations of the currency markets.

A primary objective of international economic policy coordination as practiced during the past three years has been reducing external imbalances -- especially the huge U.S. current account deficit and the enormous Japanese current account surplus. The central bankers and the finance ministers who gathered in New York and Paris saw these as troublemakers for two main reasons:

• They are necessarily associated with a corresponding capital flow in the other direction. Foreign investors, for example, help finance the U.S. deficit when they build factories, buy real estate, or purchase U.S. government and corporate securities. Partly because there is no consensus on why foreigners put their money in the United States, the ever-present fear is that they will stop. Should the foreign demand for dollars for investment diminish, the dollar's value would drop, perhaps dramatically. In addition, falling investment in securities could depress stock and bond prices, pushing up interest rates.

On the other hand, even if foreigners could somehow be induced to keep buying U.S. government and corporate securities indefinitely and making direct investments here, the problem would eventually be just as serious. The country's current account deficit would slowly spiral out of control as interest and dividend payments on accumulated portfolio and direct investment loomed larger, requiring ever-larger infusions of foreign capital unless other imbalances making up the current account improved significantly.

• All the parties to the Louvre and the Plaza Accords had an interest in resisting protectionist pressure in the United States. The Europeans and the Japanese saw protectionism as threatening their markets here, and Washington wanted to stay true to its free-market ideology. Large U.S. trade deficits were felt to fan the protectionist flames.

To attack the external imbalances, the finance ministers and the central bankers could target three main variables: exchange rates, rates of growth of national output and interest rates. But there was a problem -- the three are interrelated. The trick was to pull the policy levers in such a way that a consistent set of the three would emerge in each country that would serve to reduce the current account deficit of the United States and the surplus in Japan and elsewhere.

The Plaza and the Louvre Accords used different combinations of these policy instruments to deal with the same problem, external imbalances. The former emphasized exchange rate adjustments that were supposed to lead to export and import price changes. The appreciation of the yen was intended to drive up the dollar price of Japanese exports and reduce the price of imports, with both effects eventually working to reduce Japan's trade surplus. The depreciation of the dollar, on the other hand, was supposed to work comparable magic on the U.S. deficit.

In the Louvre Accord the problem was the same, but the solution was somewhat different. The adjustment of export and import prices as a path to external balance was deemphasized. Instead, a faster rate of economic growth in Japan, helped along by expansionary fiscal and monetary policies, was supposed to pull in more imports and, perhaps, help Japanese exporters find alternative markets at home. The United States repeated its pledge made in the Plaza Accord to attend to its budget deficit, although there was some skepticism about how much it really intended to do. The smaller the federal budget deficit, the lower would be the demand for funds to finance it and, other things being equal, the lower U.S. interest rates would be. Lower interest rates, in turn, should prove less of a magnet for funds from abroad, thereby reducing one source of the current account deficit.

Japan's own external imbalance probably also would decline if the U.S. budget deficit fell. Japan has a very high level of savings relative to its domestic needs. With high interest rates here, the United States has looked

very attractive as a place to invest those savings. A lower U.S. budget deficit would make investment here much less enticing, implying less inflow to the United States and a smaller bilateral imbalance.

The rationale behind the Plaza and the Louvre Accords is that, in an interdependent world, the costs and benefits of economic policies cross national boundaries, implying that, absent coordination, no country reaps the full rewards of or pays the full price for its actions. Multilateral negotiation can, in principle, result in beneficial trade-offs among the participant countries, thereby inducing them to pursue enlightened policies.

Further, international economic coordination is more effective, and perhaps less painful to the participant countries, than individual actions to reduce the external imbalances. For example, if both Japan and West Germany allow their currencies to rise in value, the amount of appreciation required of either to reduce their current account surpluses with the United States by a given amount is that much less. The pain, should there be any, diminishes proportionately to exporters in West Germany and Japan. And, of course, any individual action is less likely to provoke a counterproductive response if explained in advance to the finance ministers and the central bankers of other countries.

While this idea has gained wide acceptance, not everyone buys it. (For a detailed pro and con discussion of this issue, see JEI Reports No. 25A, July 1, 1988, and No. 26A, July 8, 1988.) Among the most vociferous critics has been Martin Feldstein of Harvard University, who not coincidentally was the second chairman under President Reagan of the Council of Economic Advisers. During his tenure the dollar soared against most major currencies, a process the administration did little to slow or reverse.

Mr. Feldstein and others make several points that challenge both the desirability and the feasibility of coordination:

- Coordination of exchange rate policies, they believe, promises more than can possibly be delivered in a democracy. Finance ministers and central bankers can make all the promises they want to their foreign counterparts, but they cannot necessarily bring along their legislatures or even their chief executives. Three years after the Plaza Accord, the world is still awaiting substantial progress on the U.S. budget deficit. A year and a half after the Louvre Accord, Japan has yet to deliver on its pledge of tax reform.

- Coordination often suggests an ability that is likely to prove elusive to either stabilize or move exchange rates. Mr. Feldstein argues that the influence of the Plaza Accord on currency markets has been overrated, pointing out that the dollar actually peaked against the yen in February, not September, 1985. Further, the dollar depreciated against a weighted average of industrial countries' currencies at the same rate in the year after the Plaza Accord as in the six months preceding it.[7]

Mr. Feldstein's argument comes close to suggesting that, even without the Plaza Accord, the G-7 countries may have gotten what they apparently

[7]Mr. Feldstein has made essentially similar points in several articles in academic and non-academic publications. On the question of the Plaza Accord's effectiveness and for references to other articles, see Martin Feldstein, "Correcting the Trade Deficit," Foreign Affairs, Spring 1987, pp. 795-806.

wanted: a slow depreciation of the U.S. currency. If so, the result of the accord was to advance part of the depreciation into the six months immediately after the New York meeting, with little net effect by the time a year had passed. Given an objective of a dollar valued at Y200 or a little more, the data do not convincingly show that the Plaza process got the world there any more safely than a totally uncoordinated process would have. The Louvre Accord, by contrast, advocated stable exchange rates, but the calm that followed led in short order to a financial panic on Black Monday and a falling dollar anyway.

- International policy coordination involves making choices about real or imagined trade-offs among unemployment, inflation, interest rates, exchange rate stability and other objectives. Nations naturally differ as to the weights they assign to these goals. International economic policy coordination, in other words, involves accepting to some extent another country's objectives. Europeans clearly value exchange rate stability for its own sake, Americans generally do not, and Japan is somewhere in-between. This variation might still allow successful pursuit of some overarching goals such as reducing external imbalances. However, even successful policy coordination does not ensure that these larger goals will be obtained.

- Policy coordination, its critics point out, makes all industrial countries responsible on paper but in practice no one takes responsibility. Hence, Tokyo can (and does) point at Washington for not living up to its end of the deal; Washington in turn fingers Bonn. Each one may be right: many of the policy recommendations involve painful political choices that are resisted.

Academic researchers have wrestled with the question of whether policy coordination is a good idea, often using complex formal economic models. Many have shown that the process results in small gains to the coordinating countries, but Jeffrey Frankel argued that policy coordination in a world where economic relationships are poorly understood produces less optimal results than those based on completely uncoordinated policies.[8] On the other hand, Atish R. Ghosh and Paul R. Masson argued that, provided the economic relationships are known to be uncertain, policy coordination results in some improvement compared to when there is no effort at coordinating policies.[9]

Measuring the Yen's Appreciation

Figure 1 shows the month-by-month path of the yen-dollar exchange rate since the January preceding the Plaza Accord. For comparison purposes, Figure 2 shows the year-to-year relationship since 1970. While the yen's change against the dollar has received the greatest publicity and has been the most dramatic, concentration on the dollar obscures the real picture of yen appreciation since 1985. For most of the period since the Plaza Accord, the yen has appreciated modestly against European currencies such as the Deutsche mark, changing only from 81.5 yen per Deutsche mark on September 30, 1985 to 78.5 yen per Deutsche mark on December 31, 1987. Since then the two currencies have become decoupled: by early October 1988 the Deutsche mark had dropped to 71.6 yen.

[8]Jeffrey Frankel, "Obstacles to International Macroeconomic Policy Coordination," IMF Working Paper WP/87/29 (unpublished paper, International Monetary Fund, 1987).

[9]Atish R. Ghosh and Paul R. Masson, "International Policy Coordination in a World with Model Uncertainty," International Monetary Fund Staff Papers, June 1988, pp. 230-258.

Figure 1: Monthly Yen - Dollar Exchange Rate
January 1985 - September 1988

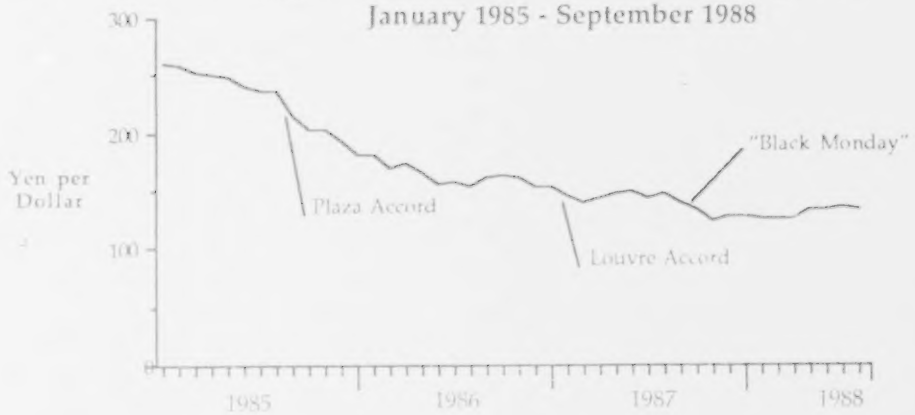
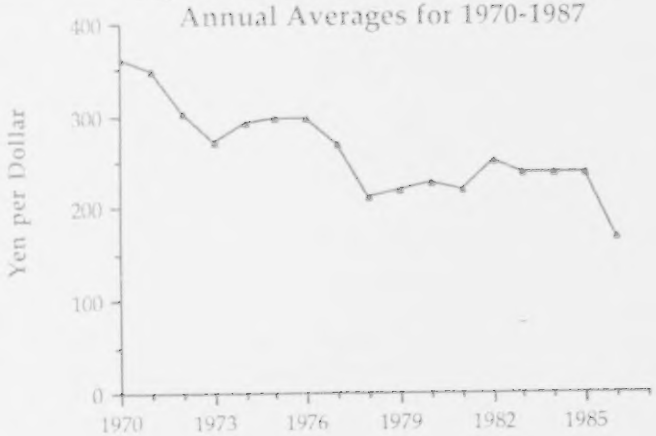


Figure 2: Yen - Dollar Exchange Rate
Annual Averages for 1970-1987



The yen's changes against Asian currencies have been more dramatic. The Japanese yen was worth 3.25 South Korean won on average in the third quarter of 1985, before the Plaza Accord could have had much effect on exchange rates. Since then the yen has appreciated almost constantly against the South Korean currency; by the second quarter of 1988 it fetched 5.9 won, a nominal yen appreciation of 81.5 percent. The substantially higher rate of inflation in South Korea -- where consumer prices rose 6.4 percentage points faster than in Japan in the twelve months ending in March 1988 -- has not been enough to offset the exchange rate change. The yen also has appreciated a nominal 72.5 percent against the Singapore dollar even though rates of inflation were slightly higher in Japan. The result has been a substantial real appreciation against these and most other Asian currencies.

Looking at each country's real, trade-weighted exchange rate index sorts these effects out. Compiled by the International Monetary Fund, the index adjusts for changes in unit labor costs, which are themselves adjusted for changes over the business cycle. Hence, when the Japanese economy was expanding rapidly in the first quarter of 1988, unit labor costs fell. This contribution to the real appreciation of the yen, however, was less than if the drop in unit labor costs had not been partly attributable to the strong economy.

This measure shows that the initial effect of the currency realignments that began in 1985 was to reverse the changes that had occurred since 1980 (Table 1). The Japanese currency recovered its real 1980 level by the fourth quarter of 1985, while it took the West German currency another year to obtain this value. The dollar fell continuously in real terms nearly every quarter but remained above 1980 values in real terms until the last quarter of 1987. Even the most recent data, for the April-June 1988 quarter, show the dollar only about 8 percent below where it was in 1980, once unit labor costs are taken into

Table 1: Real Effective Exchange Rates

(1980 = 100)

		Japan	United States	West Germany	United Kingdom
1985:	Q1	99.2	155.8	87.9	87.9
	Q2	97.5	150.6	88.2	95.4
	Q3	97.4	142.7	90.0	99.6
	Q4	104.9	132.6	92.6	97.4
1986:	Q1	113.1	123.5	95.4	91.5
	Q2	121.4	118.2	95.7	94.2
	Q3	128.6	112.3	98.1	89.8
	Q4	122.6	111.6	101.2	86.3
1987:	Q1	122.3	104.5	104.0	88.6
	Q2	127.6	101.0	104.1	92.9
	Q3	124.8	102.2	103.3	94.2
	Q4	128.7	95.8	105.7	98.2
1988:	Q1	134.2	92.5	105.5	99.7
	Q2	137.3	91.7	104.5	104.2

Source: International Monetary Fund

account. The yen, on the other hand, is 37.3 percent higher. Put differently, the realignment of currencies has been more complicated than the dollar merely dropping and the yen rising. As recently as a year ago, the United States, West Germany and Japan all had currencies that had appreciated in real terms during the 1980s. Had exchange rates stayed in the range prevailing at the time of the Louvre Accord, that situation would still be true today.

The figures also suggest that concentration on the nominal yen-dollar exchange rate has substantially overstated the effect of currency realignment since late 1985. The yen-dollar rate has changed significantly more than either currency has in real trade-weighted terms. Against the yen the dollar depreciated 47 percent in nominal terms between the third quarter of 1985 and the second quarter of 1988, but in real, trade-weighted terms it was down 36 percent.

The same is true for the yen. While the Japanese currency had appreciated by 90 percent in nominal terms against the dollar by the second quarter of 1988 compared to the third quarter of 1985, in real, trade-weighted terms the appreciation came to only 41 percent, less than half as much. To the extent that the yen's appreciation hurts, the real exchange rate is a better measure of pain. On that basis Japan has suffered less than it appears.

Effects of the Yen's Appreciation

Of course, the effects of the stronger yen on the Japanese economy were large and almost immediate. The economy went into a recession, which now appears to have bottomed out in late 1986 or early 1987. Since then growth generally has been rapid, although there has been substantial quarter-to-quarter variation. During most of the period, the external sector has been a drag on the economy's performance, sometimes enough to pull the overall rate into negative figures (see Table 2).

Table 2: External Sector and Real Japanese Growth

(contribution to seasonally adjusted quarterly growth rates)

		Exports	Imports	Net Exports	Domestic Demand	Overall Growth
1985:	Q4	-0.3%	0.2%	-0.1%	1.3%	1.2%
1986:	Q1	-0.7	0.1	-0.6	0.0	-0.6
	Q2	0.2	-1.2	-1.0	1.9	0.9
	Q3	-0.1	0.0	-0.1	1.0	0.9
	Q4	-0.1	0.1	0.0	0.7	0.7
1987:	Q1	0.4	0.1	0.5	1.0	1.5
	Q2	-0.3	-0.9	-1.2	1.2	0.0
	Q3	1.1	-0.9	0.2	1.8	2.0
	Q4	-0.2	-0.4	-0.6	2.4	1.8
1988:	Q1	0.7	-0.8	-0.1	2.8	2.7
	Q2	-0.7	-0.8	-1.5	0.5	-1.0

Source: Economic Planning Agency

The negative contribution to economic growth by the external sector since 1985 reversed the pattern of the previous half decade. In both instances, though, the influence of the external sector one way or the other was less important than the much larger domestic sector. For example, in FY 1984 (April 1984-March 1985) the external component contributed only 1.2 percentage points of the overall growth of 5.1 percent. FY 1986 was the first year since FY 1978 to show a negative contribution from the external sector.

Of course, the soaring yen brought many benefits. Oil, which is priced in dollars, became cheaper, as did many other products. More generally, lower prices for imports led to increased purchasing power, enabling Japanese consumers to spend more on both imported and domestically produced goods and services. In other words, while the yen undoubtedly had a negative effect on the net exports component of gross national product, it had a positive effect on other components of GNP.

While some domestic industries are still in the doldrums, the Japanese are rapidly forgetting how worried everyone was in early 1986 about the yen's appreciation. By many measures the economy is now far healthier than it was before the yen rose in value. For example, the effective job-opening ratio, considered a good barometer of employment opportunities, stood at 1.07 in August 1988, indicating an excess of employment opportunities over those seeking employment and the most favorable level since the early 1970s. Profits of manufacturing firms, many of which are export-oriented, sank as the yen rose but are now recovering on the strength of domestic demand and firming export markets.

Even if the yen stays in its present range, the effects of its appreciation between 1985 and 1987 will continue to work their way through the economy for some time. For example, some portion of Japan's soaring direct foreign investment is attributable to the country becoming a high-cost producer in a wide variety of products. With new announcements of foreign production plants coming almost daily and with planning, construction and startup production each taking at least months more, the effect of foreign investment decisions will be felt for years.

For those abroad the bottom line of the yen's appreciation is its effect on Japan's current account surplus. Complicating the assessment is a number of factors:

- The figure usually reported is the dollar value, but this amounts to using a rubber yardstick. International transactions with a constant volume show up as higher dollar figures, magnifying surpluses. Partly for this reason, the short-run response to the yen's appreciation was an increase in the surplus.

- External accounts are affected by many influences other than the exchange rate. One important additional factor has been the strength of the U.S. economy, which has kept the demand for Japanese exports strong.

- Seasonal factors play a major role, making unadusted month-to-month comparisons difficult.

- Some reactions to the strong yen have short-run perverse effects on the current account. For example, to the extent that Japanese manufacturers move production offshore but use Japanese-made equipment, Japanese exports

increase. At the same time, to the extent that U.S. firms become more competitive, they may expand capacity using, in part, products imported from Japan.

- Some firms have multi-year import contracts with Japanese suppliers.

- Past and ongoing foreign investment has resulted in an increased flow of dividend and interest income to Japan, which also tends to increase the current account surplus.

Japan's dollar-denominated current account surplus increased in 1986 and again in 1987. In 1988 it has declined on a year-to-year basis, although it is still very high by historical standards. Similarly, Japan's trade surplus with the United States has grown every year since 1981, although it was lower in each of the first nine months of 1988 than in the corresponding month a year earlier.

Over time Japan's trade structure will change. Exports to those countries whose currencies have depreciated the least against the yen are likely to be a larger fraction of total Japanese overseas sales. Reflecting this, the share of Japanese exports going to North America declined sharply in 1987, reversing the previous trend (see JEI Report No. 16A, April 22, 1988). Unless Asian currencies appreciate against the yen, much of Japan's import growth will come from that region. U.S. exports to Japan also are likely to rise as a result of the weak dollar.

Outlook

The yen-dollar exchange rate at any given moment reflects the consensus of all those who trade currencies or invest internationally. Investor behavior gives clues as to which direction exchange rates are likely to move.

Interest rates by most measures are higher in the United States than in Japan, and Japanese investors allocate a portion of their multibillion dollar portfolios to American assets. This suggests that, on balance, they are willing to invest in the United States, but only if they get a high enough rate of return to offset possible dollar depreciation and future swings in interest rates that could decrease the dollar value of their investments. If Japanese investors were confident of avoiding those pitfalls, they would put much more money here. Similarly, if U.S. investors were certain that they could avoid these problems, they would not invest abroad at all, yet they do. The consensus, then, appears to be that the dollar will continue declining. Given that the interest rate differential is small, the expectation is that the dollar's decline will be gradual.

Japanese life insurance companies may have employed just this logic in mid-1985, increasing their dollar-denominated investments because the difference in yield appeared to be enough to compensate for any risk. They were wrong, and they have paid a multibillion dollar price for their error. Yet they continue to invest here, apparently believing they were just unlucky before. With their billions of dollars at stake and sophisticated analyses, Japanese insurance companies illustrate the perils of trying to guess exchange rate movements.

In one sense, knowing the future yen-dollar exchange rate is unnecessary. The changes of the past three years have affected Japan in ways that may be irreversible. As the yen's appreciation has increased prices in Japan relative to the rest of the world, Japanese firms have rapidly increased their investments abroad, and Japanese consumers have become more accustomed to buying foreign products and traveling overseas. These trends may yet level off or even reverse but, should they accelerate, Japan will emerge a dramatically different country.

For further information, contact Douglas Ostrom.

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The views expresssed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.